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Banks and German Corporate Governance:
On the Way to a Capital Market-Based System?

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Abstract

The German corporate governance system has long been cited as the standard example of an insider-controlled and stakeholder-oriented system. We argue that despite important reforms and substantial changes of individual elements of the German corporate governance system the main characteristics of the traditional German system as a whole are still in place. However, in our opinion the changing role of the big universal banks in the governance undermines the stability of the corporate governance system in Germany. Therefore a breakdown of the traditional system leading to a control vacuum or a fundamental change to a capital market-based system could be in the offing.

Keywords: Corporate governance, banking system, co-determination, board of directors, complementarity, financial system

JEL Classifications: G32, G34, G38

1. Introduction

The German corporate governance system has long been regarded as an insider-controlled and stakeholder-oriented system (Franks and Mayer 1994). However, this characterization may no longer be appropriate today. Internationalisation is often argued to pressure countries to adopt a 'good' corporate governance system, usually meaning one that follows the capital market-based Anglo-Saxon model (see Walter 1993). Indeed, Germany has seen a wave of innovations in corporate governance and the financial system over the last decade. This paper argues, in particular, that the role of the big universal banks in financing and corporate governance has changed substantially in the last years. Often these developments are assumed to shift Germany towards the Anglo-Saxon model.[1]

Therefore, our paper concentrates on whether these developments indicate or foreshadow such a paradigm shift in German corporate governance. In earlier work, we have tried to identify an "inner logic" of the German corporate governance system and analysed the development of the German financial system in comparative perspective (see Schmidt/Grohs 2000; Schmidt 2001, 2004; Krahnen/Schmidt 2004). In the past, we argued that Germany exhibited a surprisingly high degree of stability and resilience to change, thereby suggesting that German corporate governance is still insider-controlled and stakeholder-oriented. This paper aims to assess whether recent developments, especially in the banking sector, may have already proved us wrong. Might Germany now be in the middle of a paradigm change?

Our answer is shaped from a systemic perspective, which suggests that corporate governance regimes are "systems" and therefore should be analysed by looking at the complementarity and consistency of their elements.[2] Having this in mind, we argue that the German corporate governance system, in the sense of a consistent configuration of complementary elements, is still an insider control system with a clear stakeholder orientation. In our opinion the changes so far have not challenged the fundamental structure of the German corporate governance. However, important changes in the behaviour of the big German banks have undermined the stability of the traditional German system of corporate governance, raising the question whether this will result in a breakdown of the old system and foreshadow a change to a much more Anglo-Saxon type of model.

[1] An overview and assessment can be found in Nowak (2001).
[2] For definitions of complementarity, corporate governance or financial system, we refer the interested reader to our other work. As will become clear, we use broad definitions of these terms. For a similar analysis of German corporate governance and employment relations, see Jackson/Höpner/Kurdelbusch (2005).

2. German corporate governance up to the 1990s

The German legal framework of stock corporations gives the management board considerable power and the task of managing the company under its own responsibility (see Kübler 1998). This can be interpreted such that not only shareholder interests, but a wider range of interests determine how a large company is to be managed. Management has to act "in the interest of the enterprise."[3]

Stakeholder orientation is also a result of the distribution of power in large German corporations. Alongside the strong role of the managing board, strong powers of oversight are vested in the supervisory board. The management board will likely give at least due consideration to the opinions of supervisory board members. However, the power and influence of various stakeholder groups depends very much on the composition of the supervisory board. Almost all large German corporations have one or a few big shareholders, which may be other companies, wealthy families or banks and insurance companies. All large German corporations are subject to mandatory employee codetermination, and almost all of them are heavily dependent on banks as lenders and as active players in corporate governance. Thus at least three groups are powerful and influential stakeholders – blockholders, employee and/or union representatives, and banks. Typically, each group plays an active role in the supervisory board. Moreover, former top managers of the respective companies occupy an increasing number of seats on supervisory boards. One can consider them as representing current management, at least indirectly. These three or four groups constitute a "governing coalition" in most large German corporations (see Mann 2002 for further details). Small shareholders and institutional investors (those not affiliated with banks) do not play an important role in German supervisory boards, and they are not part of the coalition.

Monitoring and control are made difficult by the fact that the task of management – namely to act in the best interest of the firm – is not well defined. At the same time, monitoring and control are made easier by the fact that the groups within the governing coalition have quite similar long-term objectives. This objective is clearly not the maximisation of shareholder value, but ensuring stability and growth: banks want their loans to be secure; employees and unions want job security, promotion opportunities for staff and the protection of the human capital; family blockholders want the family name and family involvement to last; top managers of other firms want stable economic structures in Germany; and ex-top managers want to protect their peers who are in charge. The common interest of

[3] For a critical discussion of this extremely vague concept in economic terms see Schmidt/Spindler (1997, 2004).

the powerful groups may amount to what some legal scholars call “the interest of the enterprise.”

Already this brief and idealised description of German corporate governance provides a clear picture of its fundamental nature or its “inner logic” up to the 1990s (see *Figure 1*). German corporate governance has a clear stakeholder orientation as opposed to a one-sided shareholder orientation. It is an insider control system as opposed to an outsider control system. It functions on the basis of internal information as opposed to public information. No active *public* takeover market acts as a market for corporate control. In Germany, the market for corporate control has been more modest and limited in the form of a market for blocks of shares.[4] We see these features of the system as being complementary and consistent.

Figure 1: Characteristics of the traditional German corporate governance system

CONTROL **vs. liquidity**	• Concentration of share ownership • Representatives of block holders on supervisory boards • Limited protection for minority shareholders
RELATIONSHIP LENDING **vs. arm‘s length lending**	• Creditor-oriented insolvency law • Reorganization capability of banks and liquidity insurance • Universal banking and participations in debtor firms • Proxy voting and supervisory board mandates
INTERNAL LABOUR MARKETS **vs. external labour markets**	• Firm-specific human capital • Strong dismissal protection, imperfect external job markets • Works councils and representation on supervisory boards • Low-powered compensation schemes
INTERNALIZ. OF INFORMATION **vs. externalization**	• Conservative, creditor-oriented accounting rules • Lax disclodure requirements even for listed corporations • No laws prohibiting insider trading

Source: Hackethal/Schmidt (2001)

One can push this diagnosis much further and compare the ways in which the members of the governing coalition and their respective constituencies participate “in the firm” and its governance. Not market forces and opportunities for “exit” according to Hirschman’s (1970) well-known dichotomy, but internal mechanisms or “voice” provide influence and protection for the three groups of active stakeholders. This explains why all groups play an active role in corporate governance.

[4] As Jenkinson and Ljungqvist (2001) report, this market is active and at times quite hostile to incumbent management. However, the participants in this market, such as banks and blockholders, belong to the governing coalition.

While we cannot review the various empirical arguments here, F*igure 2* and F*igure 3* provide performance indicators that suggest it is difficult to assess which type of system is superior in disciplining management and generating financial returns. The concept of complementarity suggests why each of the three stakeholder groups has an observable preference for their specific mode of participation in a firm: the preferences of each group are interrelated. When large shareholders opt for control and banks engage in long-term lending relationships, it becomes easier and more attractive for employees to rely on internal promotion and low-powered financial incentives, as well as to behave as partners in a codetermination regime (see also Aoki 2001, pp.287-291). Similar considerations apply to large shareholders and banks. However, if most shareholders preferred liquidity and banks opted for arm's length lending, employees would have incentives to rely on external labour markets, as in the United Kingdom and U.S.

Figure 2: Market for corporate control and executive turnover (various years)

	# of hostile takeover bids	**Block trades**	**Executive turnover**
Germany	4	10%	12,0%
France	n.a.	10%	11,0%
UK	148	9%	9,0%
USA	150	7%	n.a.

Sources: Number of takeover bids are taken from JP Morgan (2001) and Lipton (2001). Block trades exceeding 10% of total equity are taken from Köke 2001 for Germany (89-94), from Dherment-Ferere and Renneboog (2002) for France (89-91), from Franks et al (1999) for the UK (89-94) and from Bethel et al (1998) for the US (80-89, threshold: 5%). Figures for executive turnover are taken from Dherment-Ferere and Renneboog (2002).

Figure 3: Average Annual Real returns on domestic security portfolios in four countries (1960-2000)

	Stocks	**Bonds**	**50:50**
Germany	5,1%	4,1%	4,6%
France	5,2%	3,0%	4,1%
UK	5,5%	2,9%	4,2%
USA	5,9%	2,4%	4,2%

Source: Datastream and own calculations

In Germany, blockholder control, relationship lending and internal labour markets supported by codetermination form a consistent set. These elements mutually reinforce the stakeholder system of governance and internal mechanisms of control based on the private information held by the stakeholders who actively participate in the governance. On a very abstract level, German corporate governance appears rather harmonious. Of course, stakeholder interests may conflict and room exists for these conflicts. But German corporate governance includes mechanisms that preclude the dominance of any specific group interests and reduce the overall level of conflict by assuring that the common interest prevails.

This analysis should make clear that banks fulfilled a very important role in the German corporate governance system of the 1990s. Besides being represented on the supervisory board of most large corporations, banks were the main creditors, owned a significant number of large equity stakes and could extend their influence by the so-called depositary voting right ("Depotstimmrecht"). Certainly, banks were central players who ensured the functioning of the system and impeded a change to a capital market-based system. In the following we will sketch how this role changed in the last few years.

3. Recent Developments in German Corporate Governance

3.1 Legal changes

In this section we briefly present recent legal developments that are relevant for the role of banks in the corporate governance in Germany. The potentially most important – and certainly most topical - recent developments have taken place in the political arena. Four influential groups of high-level experts have recently deliberated basic issues of corporate governance and produced statements as well as corporate governance principles.[5] Our impression is that, all in all, in their widely publicised attempts to address "the corporate governance problem" in Germany, these expert groups agree on a rather simple conclusion: there does not seem to be a need to modify the *basic* structure of corporate governance in Germany. Of course, all shareholders should be treated fairly and small shareholders should certainly be treated better than in the past. But none of the expert groups has made an attempt to reinstate shareholders as the supreme authority in corporate governance matters.[6] And none

[5] See Grundsatzkommission Corporate Governance (2000), Berliner Initiativkreis (2000), Government Commission on Corporate Governance (2001), and German Corporate Governance Code (2002).

[6] This assessment only refers to the task of addressing "the fundamental problem" and should not be misunderstood as saying that these documents did not have useful roles of their own or that they did not succeed in fulfilling these roles.

of the groups viewed the role of banks in the German corporate governance as a manner of concern.

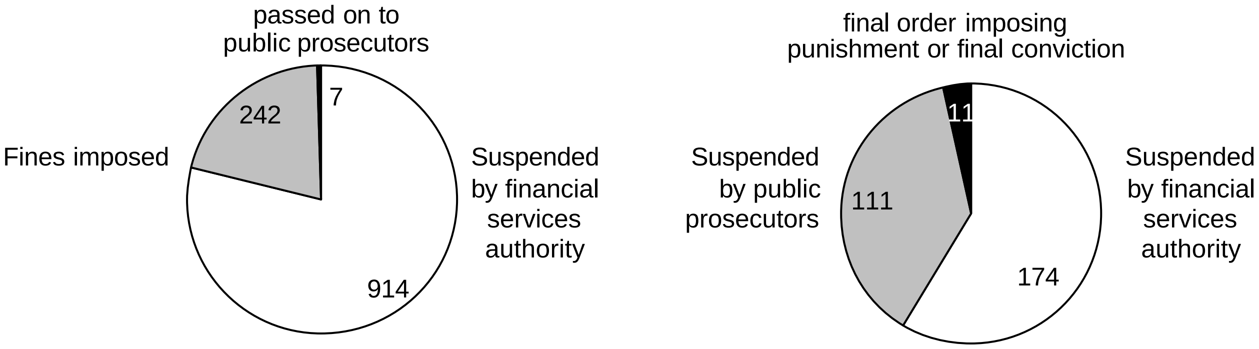
In the area of capital market law, substantial changes were initiated. Insider trading was legally prohibited. A federal authority was created to supervise certain elements of the stock market activity in 1994. Mandatory takeover bids were introduced in the new German takeover law of 2002. In combination with institutional improvements at the level of the German stock exchange system, these developments have greatly improved the quality of investor protection. The traditional assessment that the German capital markets are "underdeveloped" does not appear justified any more today.[7] Also the rating of German investor protection by La Porta et al. (1998) does not seem to apply any more.

However, the new supervisory authority Bundesaufsichtsamt für den Wertpapier-handel, (BAWe, since 2002 incorporated into the new Bundesanstalt für Finanzaufsicht, BAFin) does not have the broad mandate of the SEC of overseeing all relevant aspects of stock market activity, and it largely lacks enforcement powers. At least, this impression arises if one looks for instance at the number of insider prosecutions from the period 1995 –2001 (see *Figure 4* for more details). This fact limits the effectiveness of legally mandated investor protection,[8] and that by itself would make it difficult to interpret the new legal elements as being sufficient to introduce a capital market-based system of corporate governance.

Figure 4: Capital market law enforcement in Germany (1995-2001)

a) Concluded proceedings to impose administrative fines

b) Outcome of insider investigations



Source: German financial services authority (BAFin)

[7] See the chapters by Nowak and Theissen in Krahnen/Schmidt (2004) for details underpinning this assessment.
[8] A more general criticism of the lacking enforcement is presented in Ehrhardt/Nowak (2002). For a more general, both theoretically and empirically, analysis of the lack of security law enforcement, see also Bhattacharya/Daouk (2004)

A similar conclusion emerges from the German takeover law in 2002. It was enacted immediately *after* the narrow defeat of the EU takeover directive in the European Parliament in 2001. The German law contains most of the elements of the EU directive, including a mandatory bid rule, but stops short of disallowing all defensive measures. Thus it is also evidence of an attempt to balance improved investor protection with a continuing belief that not only shareholder interests matter.

The law of joint stock corporations has been modified to a considerable extent. The most important part of this modernization process is the "Law for the Strengthening of Control and Transparency" (KonTraG) of 1998. The KonTraG has lead to a certain shift of power to the supervisory board, thus limiting the powers of the management board. Moreover, it curtails the influence banks can exercise on the corporations by the depository voting right (Rieckers and Spindler 2004). However, it did not address the questions of how the board is to be composed and what the legal obligations of the management board should be. As this law has a clear focus on improving internal governance mechanisms, one can also not qualify the KonTraG as contributing to a paradigm shift from insider to outsider control.

3.2 Changes in codetermination, takeover activity, ownership structure and supervisory board composition

Mandatory codetermination constitutes one of the most remarkable peculiarities of German corporate governance and is a backbone of the stakeholder-oriented insider control system. Codetermination has not been challenged greatly during the past decade. This may be a matter of political correctness, but it rather seems that codetermination has worked reasonably well within the traditional system.[9] A commission composed of experts from the business community, unions and other parts of society has given a clear endorsement to the fundamental structure of German codetermination (Kommission Mitbestimmung 1998). The law concerning work councils has even been tightened and streamlined in 2001. Also the political debate on codetermination in the last months of 2004 in Germany did not lead to serious attempts to change the fundamental structure of employee relationships. To the contrary, quite a few top managers defended codetermination against attacks from the employer associations.

[9] This applies particularly for floor-shop level codetermination; see Frick/Lehmann (2005). Most recently, there have been some attempts to initiate a political debate about mandatory codetermination. However, even this discussion, so far at least, largely addresses only the full parity model of mandatory codetermination.

Hostile takeovers were even in the last 10 years rare events in Germany. To be sure, the Mannesmann-Vodafone takeover battle of 1999/2000 was indeed a hostile one, and its ultimate success seems to have marked a watershed and given a clear and simple signal of change (Hoepner and Jackson 2001). Hostile takeovers in the form of an offer to the broad shareholding public are possible in Germany. But the success of Vodafone in its attempt to take over Mannesmann did not lead to a booming active public market for corporate control in Germany. There was hardly a ripple, and certainly no takeover wave after February 2000.

Ownership concentration in the German business world is still very high by international standards.[10] It seems that they have decreased in the last few years, but these changes do not so much affect the participations of financial and non-financial corporations in other non-financial firms, but reflect rather a trend towards unravelling the overly complex web of participations within the financial sector itself. However, in the recent past the big universal banks and certain *Landesbanks*[11] reduced significantly their participations in non-financial firms.

Supervisory board composition has only slightly changed during the last decade. The number of positions and especially chairmanships held by top bankers has decreased, while - interesting enough - the role of managers of other companies and especially that of former managers of the same company has increased. The fraction of seats on the supervisory boards held by genuine shareholder representatives has not increased, as much as the fraction of shares held directly by households has reached an all-time low. Thus the facts do not support the proposition that the insider control system is giving way to a market-based system.

All in all, the individual developments observed appear to each be of minor importance. However, taking into account that banks were at the centre of so many of these changes, it is worthwhile to explore in more detail what happened with regard to the banking industry.

4. Changes in the role of banks in financing and corporate governance

4.1 The financing of business

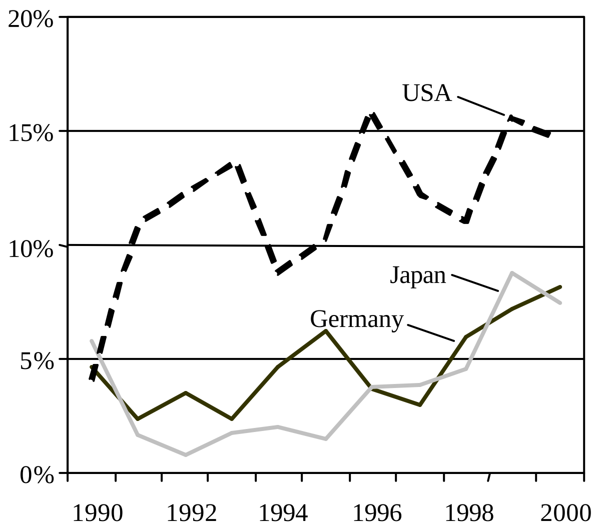
For a long time, bank financing was the dominant source of long-term external financing of German companies, and large corporations were the favourite clients of the big banks. At a

[10] See Böhmer/Becht (2001) and Faccio/Lang (2002) for details.
[11] Landesbanks constitute the second tier of the savings bank group. Typically they are owned by the respective states and as truly universal banks they compete directly with the large private commercial banks.

general level, the role of bank financing does not seem to have changed very much.[12] At least, it is far from clear whether the dominance of banks in the German financial system has been significantly eroded. Our own analysis of the financing patterns of non-financial German firms indicates that equity has increased as a source of financing. However, bank loans are still by far the most important financial source (See figures 5-7). In addition, the immense stability of intermediation ratios between 1970 and 2000 is strong evidence for the view that the role and extent of bank intermediation remains consistent with the overall logic of a bank-based system.[13]

Nonetheless, there is a need to differentiate. First, those large corporations, on which most of the corporate governance debate is focused, have become increasingly independent from long-term bank financing. For instance, the Deutsche Bundesbank indicates in their newest study of investment and borrowing behaviour of the corporate sector that the decline in bank financing is mostly driven by the behaviour of large corporations.[14] Second, the large private commercial banks seem to reduce their corporate lending activities, whereas savings banks and, to a lesser extent, credit cooperatives have not decreased their traditional banking activities, i.e. offering savings products to households and loans to individuals and small and medium-sized enterprises. The savings banks still show a high interest margin due to their

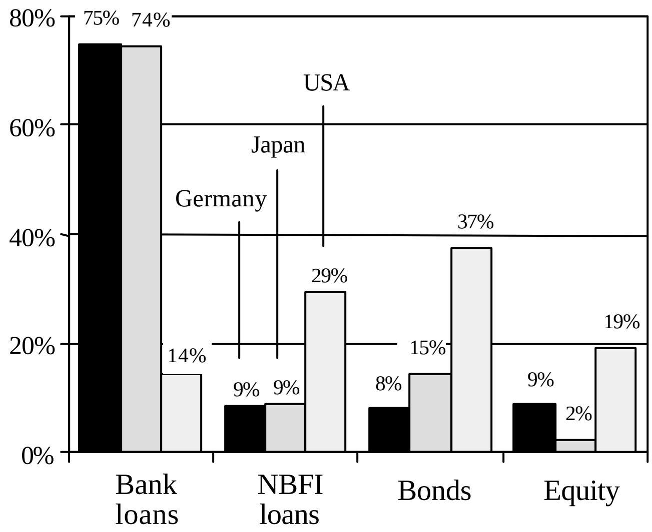
Figure 5: Total volume of equity issues over gross new investments by non financial firms



Source: Hackethal/Schmidt (2004)

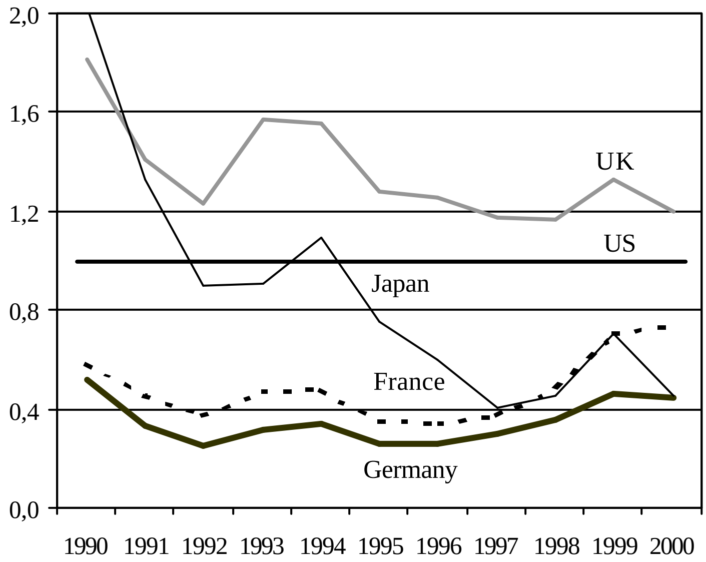
[12] See Hackethal/Schmidt (2004) and Hackethal (2004) for details supporting this claim.
[13] See Schmidt/Hackethal/Tyrell (1999) for a comparative study of intermediation and securitization ratios in Germany, France und UK.
[14] See Deutsche Bundesbank (2004a) for an analysis of the overall financial flows in Germany in 2003.

Figure 6: Breakdown of external long term financing (gross flows, average 1995-2000)



Source: Hackethal/Schmidt (2004)

Figure 7: Equity market capitalization over GDP (relative to US figures)

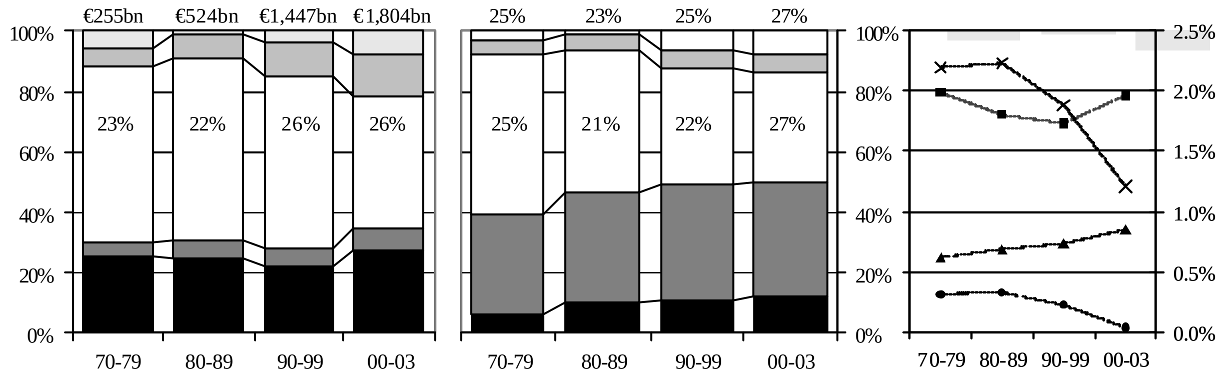


Source: DAI (2001) and own calculations

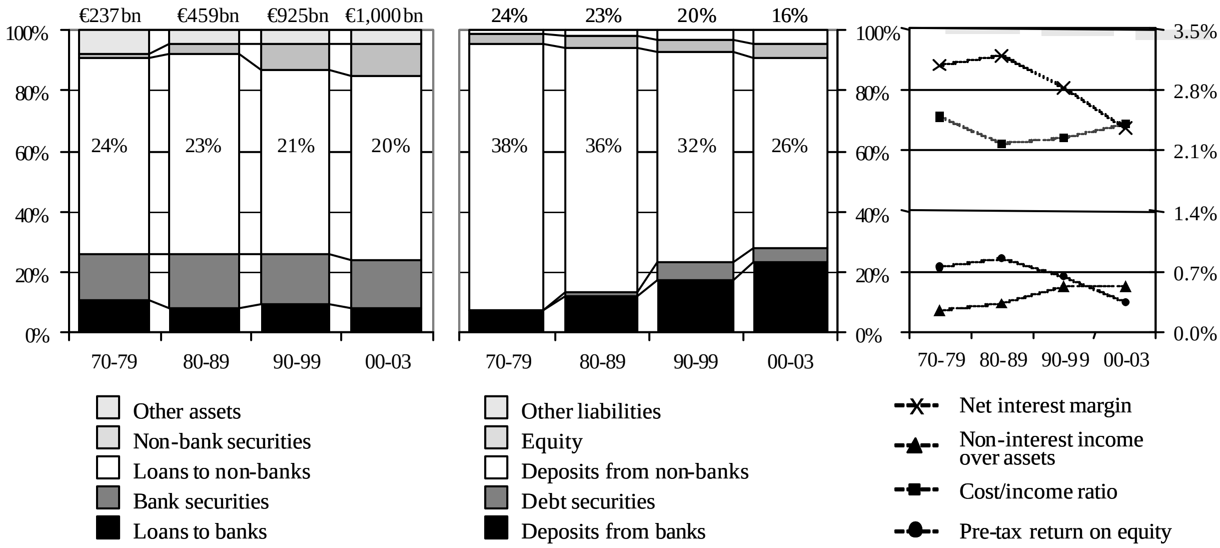
strong focus on retail banking and their economic rents from an inert deposit base (see figure 8b below on the next page). Thus, in terms of market share in total domestic bank assets, the savings bank group and the cooperative banking groups clearly dominate and even in the last years improved their position in the German banking sector. Consequently, aggregate level the financing patterns of the non-financial companies did not change a lot. However, what does the retreat from traditional commercial banking activities by the big banks mean for the corporate governance of large companies?

Figure 8: Balance sheet and income statement indicators (1970-2003)

a) Private commercial banks



b) Primary savings banks



Note: Figures above columns in the left panel show total domestic assets of all banks in the group at the end of 1979, 1989, 1999 and 2003. Percentage values indicate 5-year average market shares regarding total assets, loans to non-banks and deposits from non-banks. In the right panel, the right-hand scale applies to interest margins, non-interest income over assets and cost/income ratios. Pre-tax returns are measured along the scale from 0% to 100% on the left.
Source: Deutsche Bundesbank (various monthly reports)

4.2 The diminishing role of big banks in German corporate governance

As an overall trend of the last 5-10 years, the big 3 private commercial banks[15] appear to be withdrawing from traditional commercial loan business and attempting to refocus their relationships with large corporations through corporate investment banking activities like

[15] This refers to the Deutsche Bank, Dresdner Bank and Commerzbank, which were founded in late 19th century and established themselves as the three dominant player in the private banking sector through the 20th century. The Bayerische Hypo- und Vereinsbank (HVB), nowadays the No.2 in terms of bank assets, resulted in 1998 from a merger of two large Bavarian banks and can be characterized as a hybrid mortgage bank with a strong local retail banking focus.

underwriting, trading and advisory.[16] In the 1990s, these German banks all acquired investment banks or at least investment bank activities that allowed them to expand aggressively their activities in these directions. For instance, in 1999 the Deutsche Bank ranked first, Dresdner Bank second and Commerzbank fourth among large European universal banks in terms of the proportion of total capital allocated to wholesale and investment banking (Hackenthal 2004, pp.76). This trend also shows up in the profit and loss statements of the banks. Especially for the big banks, net interest income declined and the non-interest income over income ratio increased considerably in the 1990s, while loan volume to non-banks decreased (as can be seen from Figure 8a on page 11).[17] Even if such tendencies reversed somewhat in the last 3-4 years, the big German banks of the early 21th century certainly look very different from the same banks in the 1980s.[18] Nowadays, retail banking is conducted mainly for synergy reasons, i.e. to exercise control over a distribution channel for products originating and/or managed in other parts of the bank.

These developments might have motivated the big banks to reduce their active involvement in corporate governance. The question arises whether the old role as the main bank or house bank of the leading German corporations in nearly each industry, is still consistent with their new business strategy. Combined with the fact that the recent legal reforms already mentioned, banks face a restricted scope for active involvement in the governance of non-financial firms. These considerations might be a reason for the partial withdrawal of the private big banks from their governance role in other corporations. Moreover, competition in the banking sector became stiffer, and this also might undermine the willingness of the big banks to act in a coordinated way in their governance roles.

In addition, private benefits of control, which have clearly existed in Germany, have decreased in recent years. Studies of the value of control rights are generally regarded as an indicator for the size of the private benefits. Germany shows a marked decline in control premiums during the course of the 1990s, even if these remain substantial in comparison to the United Kingdom or the U.S. (see Schmidt 2004). This empirical evidence suggests that changes of the legal environment of corporate governance may have improved investor protection.

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[16] See Hackethal (2004) and Deutsche Bundesbank (2004b).

[17] See Hackethal (2004) and Deutsche Bundesbank (2004b).

[18] In particular, Commerzbank and to a lesser extent Dresdner Bank are now trying to strengthen their commercial banking activities anew. But it is really difficult for them to be successful in this business field since competition is stiff and in the eyes of borrowers they are not seen anymore as very reliable partner.

However, blockholders and banks which play an active – and perhaps beneficial – role in corporate governance may require a certain compensation, and this compensation might come in the form of private benefits. More transparency and better investor protection might lead to a reduction of this compensation and ultimately less willingness of those with an active role to continue playing this role. Are there already signs of banks as core players in an insider control system reducing their involvement or their willingness to co-operate in the "governing coalition"?

There are indeed such signs. Deutsche Bank is actively reducing its corporate governance role. It has given up several board seats and has introduced the rule that its own top managers should avoid chairmanships in the board of other corporations. Deutsche Bank has also undertaken several steps to reduce their shareholding and cross-ownerships. As Deutsche Bank itself hints, one reason for this shift is that the "new" Deutsche Bank simply does not benefit from its traditional governance role. The old role stands in the way of the current strategy.

In the banking sector competition and rivalry have undoubtedly increased. This trend has undermined the old established practice of banks to act in a co-operative manner in governance matters and in the case of financial difficulties of big non-financial enterprises. The conflicts between the various big banks in the recent Holzmann and Kirch insolvency cases suggest that this traditional model of behaviour is not valid any more, and with it a key element of the old governance system may be about to vanish.

Traditionally, the big banks have been the incarnation of the proverbial "Deutschland AG". The banks (and insurance companies) have indeed been the spider in the web of power and influence in Germany for several decades. However, in functional terms, one can also see their traditional role more positively: Banks seem to have kept the governing coalition stable and working to assure at least a certain level of management control. It remains to be seen what will happen if the big banks should really give this role up as they seem to be doing already.

4 Conclusion: Assessing recent developments

In conclusion, much has changed which appears to be more or less closely connected to corporate governance in Germany. Especially investor protection and the institutional basis for the control of management have improved considerably. The big banks are partially withdrawing from their traditional role in the governance of other corporations. However, a transition towards a more modern capital market-based outsider system is not yet in sight. But looking at the individual developments may provide a wrong picture. In the final analysis, what effects a given change of relevant factors may have depends very much on other – stable as well as changing - elements of the entire governance system. This systemic level is most relevant to our main question, and to this we now turn our attention.

At a general level, the answer seems straightforward. At least so far, no fundamental change has occurred. The governing coalition, which supported the insider control system, does not seem to be affected in an essential way. Stakeholder orientation has not been replaced by single-minded or radical shareholder orientation. The main players active in corporate governance still seem to act on the basis of private information. Among the most important developments, we have singled out the strengthening of the supervisory board in its capacity as monitor of management. This even points into the opposite direction, namely that of making the inside control regime even more powerful.

However, one important reservation needs to be addressed in this context. Among the more far-reaching recent developments is not only the strengthening of supervisory boards, but also considerable improvements in transparency and investor protection. Clearly, transparency and investor protection are crucial elements of an outside control system. Does this indicate a transformation of the German system? It does not, because most economic analysis suggests that shareholders who invest only on the basis of expected dividends and share price appreciation do not play a large and active corporate governance role. Improvements in investor protection will probably contribute to a (desirable) change in distribution of profits, but not to a system change. More transparency and protection for these investors does not create pressure for management to adjust its strategies. Other factors, like those in the field of corporate law, have not changed so as to reinforce the improvements for small and institutional investors and jointly constitute a radical change of the system. Moreover, many elements that support the traditional governance system, such as labour law and industrial relations, have remained largely unaltered so far.

Thus, the most important argument against convergence on a capital market-based governance system is the fact that capital markets still do not play an important role in Germany, particularly in corporate governance. In fact, in the last 2-3 years we could even observe a retreat in this respect. For instance, nearly all indicators of German capital market activity, such as stock market capitalisation, IPOs and new equity financing of non-financial companies, show a marked decline.[19] In addition, no signs point to an increasing disciplinary role of the capital markets. However, changing practices of finance and corporate governance indicate that big banks are tending to opt out of the old insider control system. It is an open but extremely important question whether this partial withdrawal of the banks from their former role also reduces the productive relevance of their involvement.

What should be clear is that these developments increase the instability of the German insider control system. The stability of the governing coalition is reduced and this could lead to a fundamental shift of the corporate governance regime in the near future. One possible consequence would be a – hopefully rapid – transition to a – hopefully well functioning - full blown market oriented corporate governance system along Anglo-Saxon lines. But the necessary conditions for this to happen are not in place and not even in sight.

A more realistic consequence in the medium term is that the effectiveness of the existing governance system will decrease and no new system will replace it any time soon. As a consequence, a control vacuum could emerge. In fact, today more chairpersons of the supervisory board of large corporations are former CEOs of the same company than ever before and former top managers are systematically replacing bankers as board members. These facts suggest that the power of management is increasing. One can seriously question whether such a development should be regarded as a move toward good governance. In addition, the growing instability in the German business environment and especially the enormous increase of average top management compensation packages in the past years suggest that we may have already reached a certain control vacuum. Then the old Berle-Means problem reappears in a more up to date outfit.

[19] See also Vitols (2004) who makes a similar point.

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